

Income Trusts in Canada: Value Loss from the Change in SIFT Taxation

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Abstract

This study investigates the market impact when Specified Investment Flow-Through (SIFT) trusts became liable to an entity tax, announced on October 31, 2006. After-tax valuation ratios indicate an initial after-tax loss of roughly 5% for Ontario taxpayers, which dropped to 3.5% when the legislation took effect in 2011. Tax integration is incomplete, as a 6.3% loss was moderated through beneficial treatment of the return of capital. Lastly, this study finds the after-tax loss for tax-exempt and foreign investors averages 25%, rather than the pre-tax charge of 31.5%. All investors were affected when income trusts were driven from the Canadian market.

I. Introduction

Income trusts were influential during their short tenure in the Canadian securities markets, but only real estate investment trusts (REITs) retained their tax-advantaged status post January, 2011. From less than 20 income trusts in 1996, the weighting in the domestic market surpassed 10% in 2006, when approximately 250 such issues were actively traded (Anderson, 2006). Early research from the Bank of Canada indicated concerns with the rapid rise of these securities (King, 2003). By 2004, their impact warranted a policy forum in which the rapid growth, tax consequences, and associated shortcomings were described (Aggarwal and Mintz, 2004; Edgar, 2004; Jog and Wang, 2004). These initial public offerings (IPOs) were the largest security issues in Canada during 2005 and 2006. Like all risky securities, there were good and poor performers in the sector but overall, the distributions provided relatively large, stable, income streams to unit-holders. Thus, trust units were popular in the low interest rate, bull market that followed the 2001 'dot-com' upheaval and preceded the 2008 market meltdown.

Investors were drawn to the high income yields derived from the beneficial tax structure and government efforts to reduce their advantage spawned several major tax policy changes. An initial attempt to level the playing field between income trusts and dividend-paying corporations involved a significant move towards tax integration in the May 2, 2006 budget, by focusing on the unequal tax treatment of dividends and interest payments. McKenzie (2006) reasoned that the trust structure still provided a tax benefit for tax-protected investors, foreign investors and others in the open market. Thus, demand for these securities continued, unabated until October 31, 2006, when the Finance Minister announced 'Tax Fairness' legislation that would impose a 31.5% tax levy, effective in 2011, on certain distributions by income trusts, redefined as Specified Investment Flow-Through (SIFT) trusts (Revenue Canada, 2006). Several studies have investigated the market response from a valuation perspective (Amoako-Adu and Smith, 2008; Glew and Johnson, 2011) and more recently, from a tax clientele perspective (Elayan et al., 2009; Edwards and Shevlin, 2011; Doidge and Dyck, 2011).

This paper extends understanding of the SIFT tax effect by considering the after-tax value loss suffered by domestic investors that paid taxes at low, middle, and high income levels and by comparing their losses to tax-exempt and foreign unit-holders. This approach improves the valuation ratio examined in the tax clientele literature (Edwards and Shevlin, 2011). By incorporating the cash payout designations, a more accurate model is provided and the study

reveals practical concerns when discerning a clientele effect. The first analysis indicates a significant loss for Ontario personal taxpayers and defines the upper and lower valuation loss bounds in that jurisdiction. The second test indicates the average effect across all thirteen Canadian jurisdictions. The derived ratio demonstrates a lack of tax integration, without the potential for future improvement.

The results indicate that investors in income trusts in all tax brackets suffered a loss in portfolio value when the government levied the SIFT entity tax, in an effort to eliminate this type of security from the domestic market. Section II outlines the designation of income trust cash flows. A description of the methodology and data relating to the assessment follows in section III, with the presentation of main results in section IV. Section V concludes the study.

II. Description of Cash Payout/Distribution

The income trust investment vehicle was a tax planning innovation derived from the Canadian Income Tax Act (Act) rules as they pertained to trusts. Income trusts fell under the mutual fund trust designation prior to their reclassification, though generally the investment focused on a single underlying operation. The legislation allowed tax-free redistribution of various cash flows from capital assets through the unit trust, providing an affordable security to be offered to income-demanding investors. Sections 104-108, 122, and 132 of the Act describe the tax treatment afforded to distributions. Herein, the nature of the distributions is disclosed to explain the impact of the SIFT legislation that became Part IX.1, section 197, of the Act, which was announced on October 31, 2006, enacted on May 17, 2008, and became effective in January, 2011.

When announced, the aim of the legislation was reported as 'leveling the playing field' by treating income trusts in much the same manner as other tax paying corporations. The original description was left sufficiently vague, however, to allow flexibility in the tax rules that were to be later drafted. The Minister allowed that certain distributions would be subject to flow-through taxation at the applicable corporate rate in order to eliminate any tax advantage, with an intention to discourage the use of SIFT-equivalent structures going forward. The message has since been misinterpreted to suggest that tax integration was intended (Edwards & Shevlin, 2011). In fact, it was understood at the time that tax integration would not eliminate the tax advantage of trusts as the unit-holders resided in several tax brackets. Tax-exempt investors, in particular, had a greater advantage than those who paid personal tax in the year the distribution was received (McKenzie, 2006). Further, foreign investors might not receive a tax advantage per se, but they represented a significant source of tax leakage, as neither corporate nor personal tax is fully recovered domestically (Mintz, 2006). Thus the true aim of the legislative change was to arrange a system to recover at least as much tax from the income trusts as would be normally charged to corporations.

There were two direct effects of the enacted legislation: 1) SIFT organizations would be taxed on non-portfolio earnings at a predicted rate of 31.5% and 2) the resulting distributions would be treated as dividends, thereby receiving an effective tax credit. Non-portfolio earnings were defined in section 197(1) as income from business carried on by the trust in Canada, other than taxable dividends received, plus net capital gains less allowable capital losses. The entity

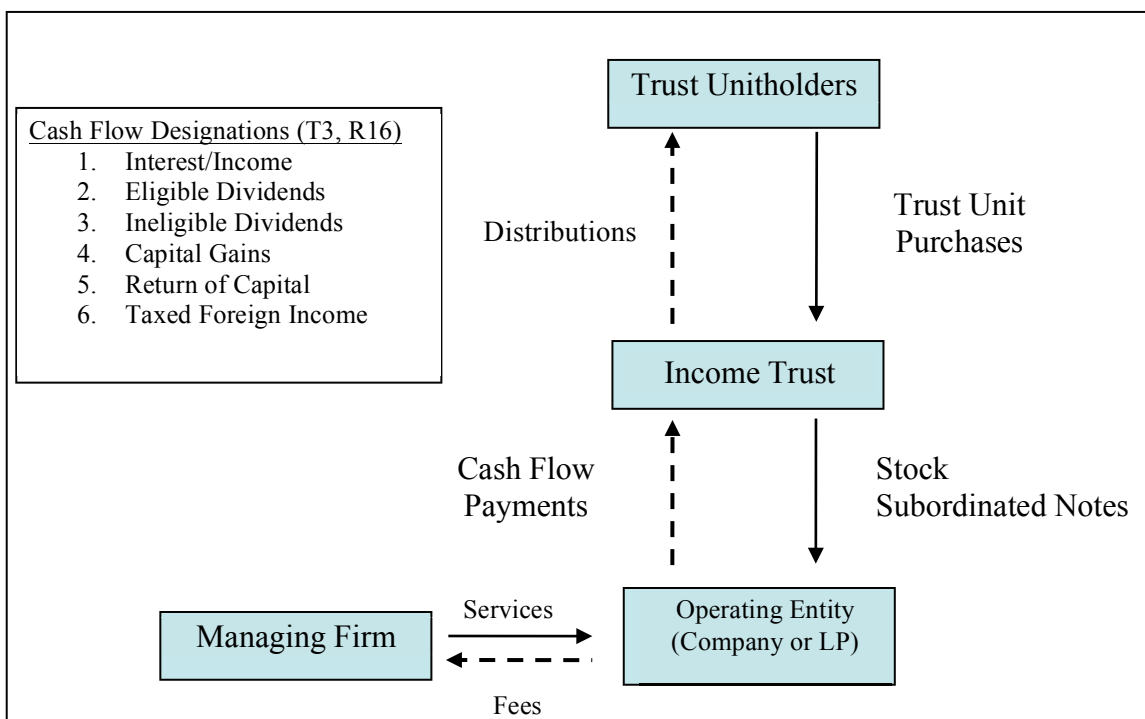
tax thus reduced the payout to all unit-holders. The reduction in pre-tax income had an immediate impact on the price of these securities in the market, providing an ideal situation for an event study in which to compare the two recent tax changes (Amoako-Adu and Smith, 2008). The drop corresponded to a rational market reaction to the loss of pre-tax payouts based on a discounted cash-flow valuation model (Glew and Johnson, 2011). The key to discerning the 2006 valuation result is recognition that the terminal value of the trust dropped in 2011, fifty months later, so the loss must be discounted.

More recently, the event was used to assess a tax clientele effect (Elayan et al., 2009; Edwards and Shevlin, 2011; Doidge and Dyck, 2011). All these researchers made convenient but inaccurate assumptions to carry their arguments forward, eliminating the some of the complexity required to understand the true effect of the tax change. Elayan et al. (2009) assume a fixed payout ratio of 100% (of earnings), treat the entire amount as interest used to reduce taxable earnings and suggest that the effect on all tax-paying investors is a slight drop in taxes paid, though no Canadian jurisdiction or tax bracket is referenced. Edwards and Shevlin (2011) begin with the premise that the Canadian tax system is integrated, so domestic taxpayers would not be affected ‘after-tax’ while tax-exempt and foreign investors would experience a 31.5% loss. This claim includes a tacit assumption that mimics that from the first paper (Elayan et al., 2009), since only the taxation of interest income and dividends were to approach integration following the tax change of May 2, 2006. Finally, Doidge and Dyck (2011) find an 18% effect after the second tax change but the authors neglect to compare this with a discounted value derived from the 31.5% loss in 2011. When discounting is included, their results compare closely to those reported earlier (Glew and Johnson, 2011). Their explanation of a prolonged market response proves more satisfactory. The shortcoming of the studies is the assumption that income trusts pay out only income in their distributions. Though this is the majority on average, consideration of the nature of the payout is necessary to eliminate a latent variable.

Income trusts are defined as unit trusts, in which capital assets in an underlying firm or partnership are held as the income generating property. There is variety in the organizational form chosen, but Figure 1 presents a typical depiction, with emphasis on the cash flows that are collected and dispersed by the trust. There are fifteen possible designations for cash that is routed through the trust, requiring annual reporting via the T3, R16, Statement of Trust Income Allocations and Designations tax form. Only six designations are commonly reported for income trusts: 1) interest/other income, 2) eligible dividends, 3) other dividends, 4) capital gains, 5) return of capital, and 6) foreign income (including the amount of foreign tax paid). Each amount has different tax history and thus deserves different tax treatment in the hands of the unit-holder.

On October 31, 2006, the Minister announced an entity level tax but did not release details of the legislative change. Some clarity was provided on November 6th and further explanations were then provided on December 22, 2012. While new tax legislation could have preserved the information provided in prior tax declarations, the enacted legislation only recognized the declared dividends as previously taxed payouts. Income from business carried on by the trust (non-portfolio earnings) would not be allowed as an expense to reduce taxes at the trust level. It would be taxed at the applicable corporate rate to replicate a dividend stream. The legislation decreased the value of the income trust distributions in the hands of all unit-holders, regardless of their tax status.

Figure 1
Typical Income Trust Structure highlighting Common Cash Flows



The SIFT amendment in Part IX.1 of the Act can be summarized as follows:

1. Interest income is taxed at the SIFT level and then treated as a dividend from the perspective of the SIFT, resulting in full taxation if the tax system integration is complete;
2. Designated dividends are unaffected, based on the definition of non-portfolio earnings;
3. Capital gains are included in non-portfolio earnings. Thus gains have been taxed at the corporate rate in the underlying firm and now are doubly taxed;
4. Foreign income is not referenced but may be further taxed; and
5. Return of capital is unaffected, retaining the benefit of deferral until the trust unit is sold.

Domestic investors subject to tax received reduced after-tax cash flows from interest income converted to dividend amounts and from capital gains that were further taxed. The Canadian tax system relies on two levels of taxation. Due to jurisdictional lags in raising dividend tax credits in response to changes in the Act, the combined tax treatment only approached integration when considering dividends. Only Manitoba and Quebec quickly announced and published their increased dividend tax credits, corresponding to the federal increases (Canadian Income Tax Act, 2006). In fact, there was a 6.5 percent loss on average, where only interest income was converted to the SIFT dividend treatment. Tax-exempt domestic investors experienced a loss of 31.5% on all income and net capital gains, but were unaffected

where return of capital, foreign income, eligible and ineligible dividends were distributed. All domestic investors were affected.

Nonresident unit-holders generally receive none of the tax benefits of the cash flow designations reported on the domestic forms. For these investors, the SIFT legislation simply reduced the size of the distribution received by the predicted tax rate of approximately 31.5%, somewhat lower where taxable dividends and return of capital flow into the SIFT trust. A withholding tax is applied, with rates sensitive to existing tax treaties. Generally, there would be no credit assessed for the SIFT tax paid, similar to treatment of other dividends received from Canadian investments. Thus, the loss of approximately 31.5% of investment earnings is the effective pre-tax reduction of income received. These investors now pay a total tax burden of 41.78%, amounting to an after-tax increase of nearly 27% (Elayan et al., 2009).

III. Data and Methodology

The SIFT legislation is included in a relatively simple model for the after-tax value of the firm using the discounted cash flow approach, with the assumption of no growth in the distribution. Despite distribution increases in the period, Glew and Johnson (2011) found the assumption of no growth provided an insignificant impact on pre-tax valuation estimates. Accordingly, time valuation theory provides that the tax reduced distribution divided by the required rate of return is the estimated after-tax value of the SIFT trust in January, 2011. Any convenient time can be chosen for security valuation at this point.

Since the SIFT legislation recognizes the dividend portion as previously taxed and return of capital as tax deferred, after-tax cash flow is determined in several steps. The distribution is first reduced by the eligible and ineligible dividend amounts and the return of capital. This portion is taxed at the SIFT tax rate, τ_S , estimated to be 31.5% at the time of the 2006 announcement to produce an eligible dividend. Prior eligible dividends are added back and that amount is further taxed at the applicable eligible dividend personal tax rate. Ineligible dividends are taxed at the ineligible dividend personal tax rate. Return of capital is not recognized until the trust unit is sold, at which time the adjusted cost base is shifted lower producing an increased capital gain. To simplify both equations below, it is assumed that sale of the trust unit is not planned and the return of capital remains untaxed for both SIFT's and pre-legislation income trusts. The sum of taxed eligible dividends, taxed ineligible dividends, and the return of capital is the after-tax cash flow received by the investor. That sum divided by the investor's after-tax rate of return provides the value of The SIFT security indicated as equation (1).

$$V_S = \frac{Dist \left\{ (1 - \tau_S)(1 - P_{div} - P_{idiv} - P_{Roc}) + P_{div} \right\} (1 - \tau_{div}) + P_{idiv} (1 - \tau_{idiv}) + P_{Roc}}{r} \quad (1)$$

Where V_S is the after-tax value of the SIFT, $Dist$ is the amount of the pre-tax distribution, τ_S is the corporate tax rate applicable to the SIFT (predicted at 31.5%), P_{div} is the eligible dividend proportion of the distribution, P_{idiv} is the ineligible dividend proportion of the distribution, P_{Roc} is the return of capital proportion of the distribution, τ_{div} is the marginal personal tax rate on eligible dividend income, τ_{idiv} is the marginal personal tax rate on ineligible dividend income and r is the required after-tax rate of return.

For the income trust, assessed prior to the SIFT legislation, the after-tax value depends on the taxation of the distribution's component parts. The dividends are designated as eligible and ineligible in 2006 and thus can be assigned to the correct marginal dividend tax rate. Interest income is reduced by the full marginal tax rate. Capital gains are taxed at half the marginal tax rate. Return of capital flows through untaxed as described above. Finally, foreign income is taxed to render the full marginal tax rate considering all taxes already paid, unless the tax rate is negative where it will be set to zero. Each designated fraction of the distribution is reduced at the applicable tax rate and the sum of these is the after-tax cash flow that was received by the income trust investor. The value of the security is the quotient of that cash flow over the after-tax rate of return, presented as equation (2), also set at January, 2011.

$$V_I = \frac{Dist \left[P_{div}(1 - \tau_{div}) + P_{idiv}(1 - \tau_{idiv}) + P_{Int}(1 - \tau_p) + P_{CG} \left(1 - \frac{\tau_p}{2} \right) + P_{RoC} + P_f(1 - \tau_f) \right]}{r} \quad (2)$$

Where V_I is the after-tax value of the income trust, $Dist$ is the amount of the pre-tax distribution, P_{div} is the dividend proportion of the distribution, τ_{div} is the marginal personal tax rate on dividend income, P_{idiv} is the ineligible dividend proportion of the distribution, τ_{idiv} is the marginal personal tax rate on ineligible dividend income, P_{Int} is the interest/income proportion of the distribution, τ_p is the marginal personal tax rate, P_{CG} is the capital gain proportion of the distribution, P_{RoC} is the return of capital proportion of the distribution, P_f is the foreign income proportion of the distribution, τ_f is the rate for the remaining tax on foreign income and r is the required after-tax rate of return.

The relative value of the SIFT from equation (1) to the income trust from equation (2) will indicate the change in value. Both valuation estimates were set at January, 2011, but we can see that the time consideration cancels out when using the ratio shown as equation (3). In fact, the ratio methodology also overcomes any inaccuracy corresponding to the zero growth assumption, but the described development is used to reduce unnecessary algebraic complexity. The valuation ratio relates the after-tax cash flows of SIFTs and income trusts to each other, avoiding the need for a cost of capital estimate. Where this ratio is less than unity, there is an after-tax loss in value due to the SIFT legislation. In the trivial case, where the distribution contains no dividends or return of capital and the unit-holder is tax-exempt or holds the income trust security in a tax-protected account, the loss is equal to the tax rate on SIFTs, which is 0.315 and the ratio equates to 0.685. The ratio for foreign investors is equivalent as the withholding tax will cancel out of equation (3).

$$\frac{V_S}{V_I} = \frac{\left\{ (1 - \tau_S)(1 - P_{div} - P_{idiv} - P_{RoC}) + P_{div} \right\} (1 - \tau_{div}) + P_{idiv}(1 - \tau_{idiv}) + P_{RoC}}{\left[P_{div}(1 - \tau_{div}) + P_{idiv}(1 - \tau_{idiv}) + P_{Int}(1 - \tau_p) + P_{CG} \left(1 - \frac{\tau_p}{2} \right) + P_{RoC} + P_f(1 - \tau_f) \right]} \quad (3)$$

Where V_S is the after-tax value of the SIFT, V_I is the after-tax value of the income trust, τ_S is the corporate tax rate applicable to the SIFT (predicted at 31.5%), P_{div} is the dividend proportion of the distribution, τ_{div} is the marginal personal tax on dividend income, P_{idiv} is the ineligible dividend proportion of the distribution, τ_{idiv} is the marginal personal tax on ineligible dividend income, P_{Int} is the interest/income

proportion of the distribution, τ_p is the marginal personal tax rate, P_{CG} is the capital gain proportion of the distribution, P_{RoC} is the return of capital proportion of the distribution, P_f is the foreign income proportion of the distribution and τ_f is the rate for the remaining tax on foreign income.

There were 215 income trusts that were directly affected by the tax change announced on October 31, 2006. This number does not include REITs (33), income trusts that had suspended distributions (12), income trusts that were involved in merger discussions at that time (8) or funds of income funds. The designations of income data were manually collected from the publicly available T3, R16 tax forms online at CDS Innovations and filled with information from the company websites, where forms were unavailable. The designations used in all calculations are those reported for 2006, when the October 31st tax announcement lowered trust unit valuations. As affected income trusts did leave the market after the announcement, consistency in results for more recent years is maintained by using these values. Table 1 indicates the summary statistics related to the tax form designations in each of the six categories and demonstrates that there is no typical payout structure, though the largest percentage of the payout is generally the interest or income portion. Less than 22% (47/215) paid only interest or other income to investors and only 7 trusts paid distributions solely from other sources.

Table 1
Income Allocations on 2006 T3, R16 Tax Forms

Of 215 income trusts that were adversely affected by the SIFT tax legislation, income was designated into six categories as indicated in the Table below. For the maximum and minimum values the number of designations in the sample is indicated below the percentage in parentheses.

Designation	Eligible Dividend	Ineligible Dividend	Interest/Income	Capital Gain	Return of Capital	Foreign Income
Minimum	0 (165)	0 (196)	0 (5)	0 (205)	0 (79)	0 (207)
Mean	0.05	0.01	0.78	0.00	0.15	0.01
Median	0	0	0.88	0	0.03	0
Maximum	1 (1)	1 (1)	1 (47)	0.10 (1)	1 (3)	0.23 (1)

Personal income tax data were collected from Tax Tips website (2011) and verified with the tables provided in published copies of the Acts (2006, 2008, 2010, and 2011). The latter years are included to demonstrate that further movement towards integration has not occurred as intended by the legislation of May 2, 2006. The dividend tax credit information for Ontario and the other jurisdictions was checked against the data listed on the provincial tax forms, retrieved from the Revenue Canada website (2011). Ontario provides the initial comparison since it is the most populous Canadian province with the largest financial centre, whose tax rates generally span those in other jurisdictions. All Canadian jurisdictions are compared in the second analysis.

IV. Results

The calculations for low, middle and high marginal personal tax rates indicate a sizable disparity in the results across the rates, but all average ratios are less than unity. In no case was the value of the SIFT greater than the previous valuation of the income trust. Table 2 includes the valuation ratios for four taxation levels in three calendar years. For the income trusts that simply

redistributed dividends or paid return of capital from the underlying operating entity, the maximum valuation (unity) is received. Five income trusts distributed such funds, with one distributing only eligible dividends and one distributing ineligible dividends. The minimum results correspond to those trusts that distribute all cash as interest or capital gains. In the tax-paying brackets in all years, higher rate payers suffer greater after-tax percentage losses in this category, which is opposite to the effect in the mean result.

Table 2

Valuation Ratio of SIFT/Income Trust at Different (Ontario) Personal Tax Rates

For 215 income trusts, the after-tax valuation of the SIFT is divided by the Income Trust valuation, prior to the legislated tax change, as indicated in equation (3):

$$\frac{V_S}{V_I} = \frac{\left\{ (1 - \tau_S)(1 - P_{div} - P_{div} - P_{Roc}) + P_{div} \right\} (1 - \tau_{div}) + P_{div} (1 - \tau_{div}) + P_{Roc}}{\left[P_{div} (1 - \tau_{div}) + P_{div} (1 - \tau_{div}) + P_{Int} (1 - \tau_p) + P_{CG} \left(1 - \frac{\tau_p}{2} \right) + P_{Roc} + P_f (1 - \tau_f) \right]}$$

The tax rate for the SIFT, $\tau_S = 31.5\%$, as predicted by the government in the announcement of the change. The expression is evaluated at a zero tax rate, to indicate the effect on distributions paid to pension funds or tax-protected personal plans such as RRRSP's and TFSA's, and at three marginal levels to span the Ontario tax rates in 2006, 2008, 2010, and 2011. In 2010, the Ontario combined corporate tax rate dropped below the nominal 31.5% quoted in the 2006 press releases and thus the actual Ontario corporate tax rate was used for calculations in 2010 and 2011. No mean ratio equals unity, indicating a net loss to unit-holders in all cases without conversion to avoid the additional taxation at the SIFT entity level. The 'All Income' row demonstrates incomplete integration in the tax system for all years considered.

Valuation Ratio	$\tau_p = 0\%$	$\tau_p = 21.30\%$	$\tau_p = 32.98\%$	$\tau_p = 46.41\%$	Foreign Investor
2006 Maximum	1	1	1	1	1
All Income	0.69	0.92	0.93	0.96	0.69
Median	0.72	0.93	0.94	0.97	0.72
Mean	0.75	0.94	0.95	0.97	0.75
Minimum	0.69	0.90	0.87	0.81	0.69
2008 Maximum	1	1	1	1	1
All Income	0.69	0.93	0.94	0.97	0.69
Median	0.74	0.96	0.97	0.99	0.74
Mean	0.76	0.96	0.96	0.99	0.76
Minimum	0.69	0.91	0.87	0.81	0.69
2010 Maximum	1	1	1	1	1
All Income	0.70	0.94	0.93	0.96	0.70
Median	0.75	0.97	0.96	0.98	0.75
Mean	0.77	0.96	0.96	0.97	0.77
Minimum	0.70	0.90	0.87	0.81	0.70
2011 Maximum	1	1	1	1	1
All Income	0.72	0.94	0.94	0.97	0.72
Median	0.7	0.96	0.96	0.99	0.75
Mean	0.79	0.96	0.96	0.98	0.78
Minimum	0.72	0.88	0.87	0.81	0.72

Ontario taxpayers that invested in a portfolio of income trusts lost value, due to double taxation and lack of tax integration. The second row presented for each year corresponds to the income trusts that distributed only interest or other income to the unit-holder: the portion of the Canadian system assumed to be integrated by the May, 2006 legislative change to increase the dividend gross-up amount and the level of the dividend tax credits. In fact, only Manitoba and Quebec followed the federal government's lead on this by August, 2006. Ontario announced their intention to raise the provincial dividend tax credit to 7.7% at that time, but reneged on such a move until the 2009 tax year, when a lower credit of 7.4% was implemented with reductions thereafter. Simple averaging of the three tax-paying classifications indicates that there remains a loss of 6.3% when receiving a dividend rather than an income payment in Ontario, where 39% of Canadians reside. As a federation with income tax structure determined at two levels, the integration between interest payments and dividends has not been achieved. Integration with respect to capital gains and return of capital has not yet been proposed.

Summarizing these results with a focus towards determining a tax clientele effect is quite difficult. When an investor or fund is tax-exempt, the ratio was expected to equal 0.685 but it does vary with a changing dividend designation and in five cases where dividends or return of capital were distributed by the income trusts, there are no losses in value. As well, the mean after-tax loss of 24.8% (median of 27.8%) is lower than the median pre-tax loss of 31.5% experienced by all unit-holders of the SIFT securities and cannot be separated from that effect. A generalized result on marginal investors could only be made via an assumption that the announcement had no other valuation effect in the market, as was the case in the Cannavan, Finn and Gray (2004) Australian study. The mean after-tax losses of almost 5% across all tax-paying levels further indicate that this is not the case in the Canadian context. There is no comparison group of investors that were unaffected by the change on October 31, 2006.

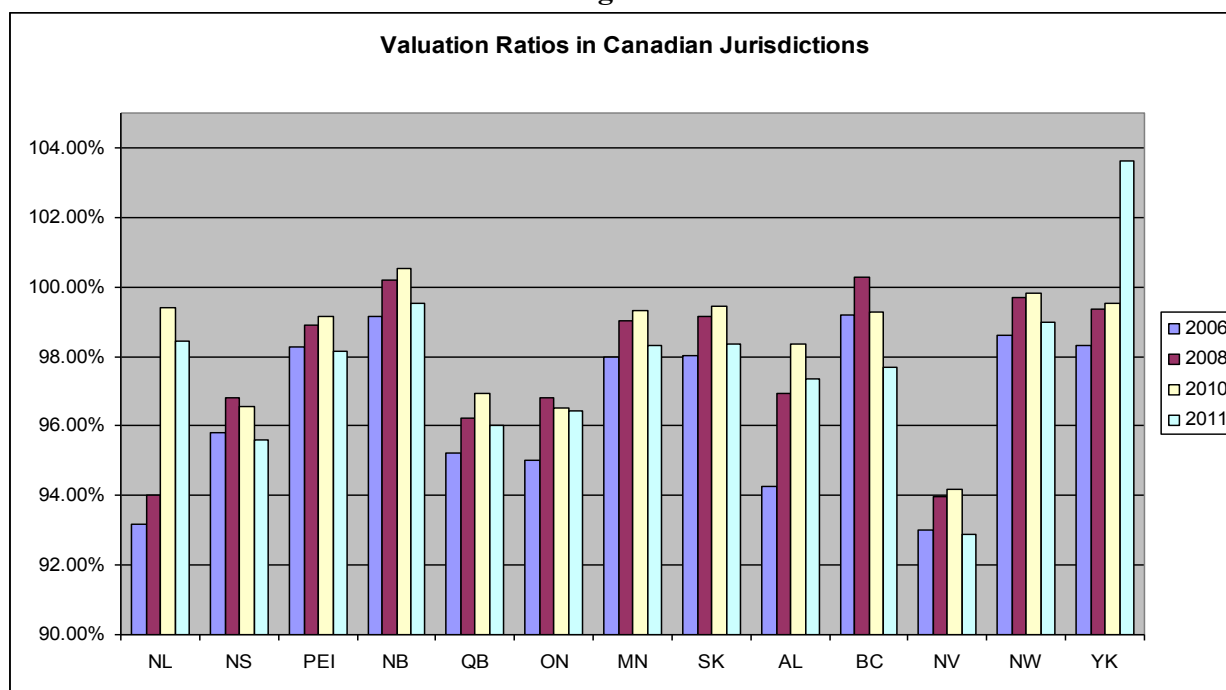
Past studies describe the effect in the highest tax bracket (46.4%), while these data allow a comparison between three tax-paying clienteles. Generally, the after-tax loss was smallest for those in the highest bracket, whose ratios are closest to 100%. The minimum ratios display the reverse pattern, however, where greater losses were experienced by domestic investors in the higher tax brackets, an effect that works counter to tax clientele arguments. The 19.1% loss indicated in the highest tax bracket is approximately 12.5% from the 31.5% maximum loss for tax-exempt and foreign investors, whereas domestic investors in the lowest tax bracket are separated by almost 21.5%. Without knowledge of the income trust holdings of investors in the different tax brackets, generalization of the legislation's effect becomes untenable.

More recent tax years are included to illustrate that conditions have not changed significantly since 2006. The enacted legislation greatly disadvantaged the distribution of capital gains. Integration has not yet been achieved in the Canada's most populous province. The legislation did retain return of capital as an untaxed amount, however, which softened the effect of the change, creating less impact on tax-exempt and foreign investors. Though the data were obviously not available to investors in 2006, we do see that the separation between highly taxed individuals and tax-exempt individuals is further reduced in recent years. Greater differences are uncovered when several jurisdictions are considered.

To judge the extent of integration across all jurisdictions in Canada, the valuation ratios were estimated for three marginal personal taxation levels in each region. The overall average in each year for each jurisdiction is graphically depicted for comparison in Figure 2, which clearly shows variation in the overall average across the regions, relating to the varying taxation levels typical in a federation. Originally losses ranged from 1% in New Brunswick and British Columbia to 7% in Newfoundland and Nunavut. The average results skew towards the low end if relative populations are considered, since Quebec and Ontario indicate losses around 5%. These two provinces combined account for 62% of the population in the 2006 census.

A time trend is also apparent. Although ten jurisdictions adjusted their dividend tax credits in 2006, albeit at partial levels relative to the existing corporate tax rate, most others adopted a higher rate two years later. Several provinces and the federal government subsequently reduced the dividend tax credits to make the income trust structure 1-3% less attractive by 2010. The federal tax credit dropped by 1.2% and five jurisdictions also lowered their credits from the 2008 levels. This resulted in an additional 1% gap between dividend tax treatment and interest tax treatment. The advantage to debt financing has been gradually increasing with dividend credit claw-backs, re-establishing a known concern in the Canadian tax system (Department of Finance 1997).

Figure 2



The average results at each tax level are consolidated into seven regions in Table 3. Regional tax levels differ in percent rates across the sample but remain relatively stable throughout the four year period. Variation in results in Table 3 is largely attributable to changes in the dividend tax credit. In all cases, there is a loss in the after-tax valuation as a result of the SIFT tax legislation in 2006, costing high marginal tax-payers as much as 6.3% in Alberta. The loss is greater at higher marginal tax rates throughout most of the table, but the population

weighted averages are remarkably similar in a given year. In later years, several jurisdictions were close to achieving integration at all tax levels, with British Columbia over-reaching in 2008. Population weighted averages increased until 2010, when a minimum difference of approximately 2% was reached. By 2011, the corporate tax rate had dropped below the estimated combined corporate rate of 31.5% in most jurisdictions, so tax dividend tax credits were further reduced.

The majority of Canadian investors, who owned a diversified portfolio of income trusts, lost value due to the SIFT tax. Only those receiving solely dividends or return of capital were unaffected. In fact, the value of the income trust organizational form to those firms that distribute only dividends is puzzling, and perhaps relates to non-monetary considerations. Return of capital remains an effective method to monetize the depreciation tax benefit, but a payout derived from only these funds seems unsustainable.

Table 3
Mean Valuation Ratios for all Jurisdictions in Canada

For 215 income trusts, the after-tax valuation of the SIFT is divided by the Income Trust valuation, prior to the legislated tax change, as indicated in equation (3):

$$\frac{V_S}{V_I} = \frac{\left\{ (1 - \tau_S)(1 - P_{div} - P_{div} - P_{Roc}) + P_{div} \right\} (1 - \tau_{div}) + P_{div} (1 - \tau_{div}) + P_{Roc}}{\left[P_{div}(1 - \tau_{div}) + P_{div}(1 - \tau_{div}) + P_{Int}(1 - \tau_p) + P_{CG} \left(1 - \frac{\tau_p}{2} \right) + P_{Roc} + P_f(1 - \tau_f) \right]}$$

The tax rate for the SIFT, τ_S , is the lower value of the predicted rate of 31.5% given by the government on announcement of the change and the combined corporate tax rate of the SIFT's jurisdiction. For example, in 2008 Alberta's combined tax rate was 29.5% which is used for all trusts residing in Alberta, but Ontario's combined rate was 33.5%, so the predicted rate of 31.5% is used for all trusts in that jurisdiction. In 2011, the actual corporate tax rate in the appropriate jurisdiction is used. The expression is evaluated at three marginal personal tax levels spanning the tax rates in each jurisdiction in 2006, 2008, 2010, and 2011. The rates do not match exactly due to regional disparities, but these are chosen as the low, middle, and high rates, where the middle rate is closest to the median level. The mean ratio for each tax rate in each jurisdiction for the indicated years is included in the table.

Jurisdiction	Year	Tax Exempt/ Foreign Investors	Lowest Marginal Tax Rate	Middle Marginal Tax Rate	Highest Marginal Tax Rate
Atlantic Provinces	2006	0.75	0.97	0.97	0.96
	2008	0.76	0.98	0.97	0.98
	2010	0.77	0.99	0.99	0.99
	2011	0.79	0.98	0.98	0.98
Quebec	2006	0.75	0.96	0.95	0.95
	2008	0.76	0.97	0.96	0.96
	2010	0.77	0.97	0.98	0.96
	2011	0.79	0.97	0.96	0.95
Ontario	2006	0.75	0.94	0.95	0.97
	2008	0.76	0.96	0.96	0.99
	2010	0.77	0.96	0.96	0.98
	2011	0.79	0.96	0.96	0.98
Manitoba & Saskatchewan	2006	0.75	0.98	0.98	0.98
	2008	0.76	0.99	0.99	0.99
	2010	0.77	1.00	0.99	0.99
	2011	0.79	0.99	0.98	0.98
Alberta	2006	0.75	0.95	0.94	0.94
	2008	0.76	0.97	0.97	0.97
	2010	0.77	0.99	0.98	0.98
	2011	0.79	0.98	0.97	0.97
British Columbia	2006	0.75	0.99	0.99	0.99
	2008	0.76	1.00	1.00	1.00
	2010	0.77	1.00	0.99	0.99
	2011	0.79	0.98	0.98	0.97
Northern Territories	2006	0.75	0.97	0.97	0.96
	2008	0.76	0.98	0.98	0.97
	2010	0.77	0.98	0.98	0.97
	2011	0.79	0.99	0.99	0.98
Population Weighted Average	2006	0.75	0.96	0.96	0.96
	2008	0.76	0.97	0.97	0.98
	2010	0.77	0.98	0.97	0.98
	2011	0.79	0.97	0.97	0.97

The loss in value can only be recouped through elimination of the redundant level of the trust organization, which now carries its own entity tax. Capital gains have been doubly taxed, so retention of these funds is now preferred from a tax perspective. The alternative would be a highly levered structure without the trust layer, allowing the funds to flow directly from the underlying assets to investors comfortable with exposure to risky debt. Privatization is one possibility, whose advantages were recognized prior to the legislation (McKenzie 2006). Otherwise, a market for high yield debt securities or convertible securities must be established.

V. Conclusion

Notwithstanding the legal interpretation of the Act's wording (Bloom and Wiener 2011), Part IX.1 effectively penalized income trusts, which became known as SIFTs, through an additional entity level tax uncharacteristic of those pertaining to other trusts. Canadian taxpayers that owned income trusts were disadvantaged by the decision in two respects: 1) pre-tax cash flows to investors were reduced, and 2) the post legislation after-tax cash valuation of the SIFT is reduced. Unfortunately, simplification in cash flow models does not allow consideration of each

effect independently as both occurred simultaneously on the eve of the tax change announcement on October 31, 2006.

Despite best intentions of movement towards an integrated tax system, straight taxation of interest or income payments remains below the taxation of dividends, carried out at two levels. This study assumed the predicted corporate tax rate of 31.5%, which was below the combined rates for most Canadian jurisdictions in the years studied. Our analysis uncovered a retrenching towards lower dividend tax credits. As such, there was no representative comparison group of trust unit-holders without a valuation loss effective on October 31, 2006. Without a greater knowledge of the holders of income trust units and their portfolios, measuring a clientele effect is untenable.

In hindsight, we can see that the SIFT legislation (Part IX.1, section 197) enacted to level the playing field has only one logical conclusion: the demise of income trusts in all industries with the exception of the real estate sector. The additional level of administration that was once affordable has become costly with an additional level of taxation at the SIFT entity level. The presented model quantifies the relative loss in the after-tax value of those trusts affected by the legislation, based on their 2006 T3, R16 income allocations, assuming no conversion. By converting to a standard corporate form, the organization can avoid double taxation of capital gains but cannot totally recoup the value lost on October 31, 2006.

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